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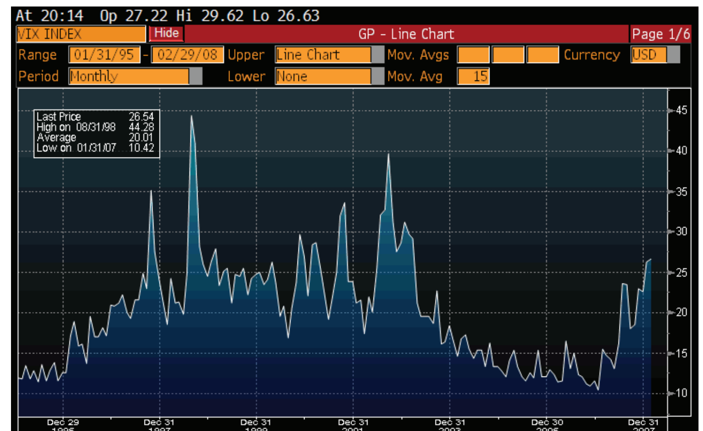
Volatility Opportunities

In markets like this, I am reminded of a story about Albert Einstein. One year he set an exam for his students that was identical to the previous year. One of the more honest students pointed this out and Einstein's reply was that, although the questions might be the same, the answers were different.

These are uncertain times. Investors are faced with a range of outcomes ranging from rapid recovery to long term recession, with an inflation mixer. As a result, financial markets are suffering significant short term mood swings. Good news and bad news days follow on from each other in rapid succession. So far in March, we have seen the Dow rise 416 points on 11th March when the Federal Reserve announced that it would lend up to $200bn of Treasury securities to primary dealers in exchange for mortgage backed securities and then fell 194 just a few days later when Bear Stearns collapsed.



A good measure of uncertainty is the Chicago Board of Options Exchange Volatility Index, usually referred to as the VIX, which is a weighted average of option implied volatility.

After three and a half years in hibernation, volatility started to rise in the middle of last year and is rapidly regaining levels last seen during the run up to the market peak in 2000 and the subsequent decline. Only the Russian debt crisis and Thai currency collapse caused greater uncertainty. Uncertainty and, therefore, volatility is likely to be with us for quite some time and so the interesting question to address is what to do and even better, what investment strategies will actually benefit.

During periods of high stress and volatility, selling options can prove effective. With fear spreading, there is a greater potential for over pricing options, thus giving increased premiums and, as expiry draws closer, the time value erodes just the same - you can't wind the clock back. Various strategies work particularly well at times like this. For example, selling out of the money puts and calls (rather worryingly known as a strangle) on the FTSE 100 Index is more profitable at present and due to higher volatility, the index range within which you would make a profit, is up to double that of a year ago. For similar reasons, selling out of the money puts on cheap companies is a good way of reducing the potential purchase price even further from current depressed levels.

In contrast, buying options either to benefit from a quick recovery in prices or to provide an insurance policy on the market is much more expensive and, although superficially attractive, probably best avoided at present. As markets have declined, investors naturally look for protection and structured products are a popular solution. Unfortunately, standard structured products providing 100% capital protection and upside participation to a market recovery have become much less attractive in recent months. Lower interest rates make the protection more expensive and higher volatility increases the cost of the options held to provide the gain. There are, however, attractive strategies that involve selling volatility, such as autocallable notes, which deliver an attractive return if the index trades higher than its starting level on the anniversary date. At the start of this year a typical autocallable note might have offered a yield of 12% per annum. This has now risen to over 15% despite the fact that the market is significantly lower. These notes extend over a number of years and you have to be particularly bearish to believe that the index will be lower than it is today in, for example, five years time. The terms of these notes vary but most offer partial capital protection. Both options and structured products are beneficiaries of uncertainty, but investors need to properly understand the factors that drive pricing. Simplistic concept like 'buying insurance' or 'full capital protection', come at a high price during periods of uncertainty.

We hear a lot about hedge funds at the moment, either as instigators of volatility or because of over leverage. Those trading in illiquid markets using a lot of borrowed money are suffering a painful squeeze and there are likely to be further casualties to join Peloton and Carlyle Capital. There are also a number of hedge fund strategies that tolerate volatility and some that positively thrive. Long/short equity hedge funds make up a substantial proportion of the hedge fund sector. Most use relatively little leverage and, in theory, should benefit from volatility. In practice, current conditions are particularly tough and the results so far this year suggest that the average long/short fund is breaking even, which is satisfactory given that equity markets are down over 10%. The real beneficiaries of volatility in the hedge fund arena are macro funds, which invest in a range of strategies designed to extract value from changing interest rates, foreign exchange, equities and commodities. The current environment is ideal for them and the average return up to the end of February was +7.5%.

Returning to the volatility chart, it is clear that during a market setback, volatility rises, but no advance warning is given and so VIX is not particularly useful as a lead indicator. What is, however, worth noting is that once volatility moves up, it stays high for quite a while, which means that the strategies outlined are likely to keep working for some time. On reflection, this makes sense because investors lose their nerve collectively and only regain their courage individually. So while we grapple with the challenges of the credit crunch and a general slowdown of economic activity, investors prepared to look for opportunities will find plenty to do.

David Miller - March 2008

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